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LEGISLATIVE AND REGULATORY UPDATE

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I. H.R. 6 – THE ENERGY POLICY ACT OF 2003

A. Status

The Senate leadership on November 21 fell two votes short of gaining the required 60 votes to end a filibuster on the final comprehensive energy bill that was crafted by a House-Senate conference committee over the last several months. A bi-partisan group of Senators balked at the bill's \$31.1 billion price tag and a controversial provision giving producers of the fuel additive methyl tertiary butyl ether (MTBE) liability protection from defective product lawsuits. Although the two issues were also hotly debated in the House, that chamber passed the bill three days earlier in a 246-180 vote. The tax credit provisions in the pending energy bill have, of course, been the primary focus of the landfill gas industry.

Senate Majority Leader Bill Frist (R-TN) announced that the Senate will take up the energy bill again in February once the Senate clears the FY 04 omnibus appropriations bill. That bill, which would fund the bulk of federal agencies during the current fiscal year, which began more than 2 months ago, is itself controversial and could get bogged down in the Senate, delaying action on the energy bill. Apparently, during the Holiday recess, the Republican leadership in both the House and Senate has been trying to muster up the two additional Senate votes needed to overcome the filibuster of

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the energy bill. This is no easy task, as every promise made to change a provision in the bill to gain votes will undoubtedly result in a loss of votes.

Importantly, House Majority Leader Tom Delay (R-TX), and some Senators representing oil refining states, are adamantly opposed to removing the MTBE liability provision from the bill to the chagrin of several Republican Senators from states in the Northeast with communities that have suffered MTBE contamination. Democrat Senators, many who are also opposed to the MTBE provision, have additional issues with the bill, prominent among them is the lack of a renewable portfolio standard for electric utilities and a greenhouse gas reduction program. Notwithstanding, there are rumors floating on the Hill that the Senate leadership has secured the additional two votes needed for cloture. But this is only a rumor.

Even more critical is the opposition to the energy bill's price tag. The bill costs almost 4 times more than the Bush Administration had proposed. It is possible that the Senate leadership will be able to pressure some of the Senators who voted "no" on the bill because of its cost to switch their votes and end the filibuster. However, this would be a short lived victory as other Senators who oppose the cost of the bill are still committed to raising a point of order that the bill violates the Budget Act. To overcome a budget point of order, and allow the bill to be adopted by the Senate, also requires 60 votes. It will be much harder, and perhaps impossible, for the Senate leadership to convince Republican budget hawks to vote against the point of order.

Although the Administration urged the Senate to pass the energy bill last November, since then its position on passing the bill has been unclear and its uncertain how engaged it will be in February when Senate takes up the bill. The Administration, already facing criticism in this election year for the huge and long-term federal budget deficit facing the country, is likely to avoid the risk of getting into a squabble with Senate Republican budget hawks over the cost of the bill. Still, it would appear that the Administration could get the Senate to pass the energy bill if it wanted it enough.

So what is the bottom line on the fate of the energy bill? It is simply this: no one knows and no one will really be able to divine much more until we get closer to that point in February. And if it provides any solace, know that what ever happens to this energy bill is now beyond the control of you and I.

B. Legislative Fall Back Options

If the Senate fails to pass the energy bill, the bill dies unless both the House and Senate adopt a concurrent resolution to recommit the bill to the House-Senate conference committee. If no such resolution is adopted, there are still some actions Congress can take this year to save the text of the bill, or most of it, and get it enacted. The House could try to fashion a new energy bill that would be modified sufficiently to secure 60 "yes" votes in the Senate. Once passed by the House, it would send the bill to the Senate for concurrence, and if approved by that chamber, it would be sent to the White House for the President's signature. An alternative course of action, although a less likely

scenario since House Speaker Dennis Hastert (R-IL) has indicated opposition to it, is for the House to attempt to pass sections of the energy bill as separate pieces of legislation and seek concurrence from the Senate on each.

The tax provisions of the current energy bill could also be modified to reduce their overall cost and gain acceptance in the Senate. The modified tax provisions could then be attached to a final Omnibus FY 05 Budget bill that Congress will likely be forced to pass at the end of the year. Or the tax provisions could be attached to another legislative vehicle that is likely to be enacted this year, or must be enacted such as a continuing resolution to keep the federal government funded if the Congressional appropriations process falters. On the other hand, these options are not limited to the tax provisions but could be utilized for any other sections in the current bill.

C. Tax Provisions

We were successful in having new tax credits for utilization of LFG included in the bill, although Congress clearly indicated its preference for the simplicity of providing such credits for generating electricity rather than developing landfill gas as a fuel. There are several other tax provisions in the bill, described below, that warrant attention of the LFG industry.

Unfortunately, the provision allowing state and local government entities to take tax credits for producing electricity from renewable resources and trade or sell them to tax paying entities was not adopted by the conference committee because of opposition voiced by the Administration and from key House Ways and Means Committee members. The provision was originally contained in the Senate version of HR 6 and was intended to provide incentives commensurate with the private sector in light of the chronic under-funding of the Renewable Energy Production Incentive (REPI) Program. The REPI program provides direct payments to state and local government entities for producing electricity from renewable resources. In exchange for dropping the provision, its sponsor Senator Chuck Grassley (R-IA), Chairman of the Senate Finance Committee, obtained a commitment from the Senate chairman of the conference committee, Senator Pete Dominici (R-NM), who is also Chairman of the Senate Appropriations Subcommittee for Energy and Water Development, that he will agree to provide increased funding for the REPI program in FY 05.

The relevant tax provisions in the energy bill are as follows:

1. Amendments to I.R.C. Section 45

New tax credits are provided to owners of facilities that produce electricity from the combustion of MSW or LFG. The tax credit would apply to both types of facilities if placed in service after the bill's enactment date and before January 1, 2007. The tax credit is equal to 1.0 cent/kilowatt-hour (indexed for inflation from 1992 - the value in 2003 would be 1.2 cents/kilowatt-hour) of electricity produced. The tax credits would be provided for a 5-year period beginning on the date that the facility is first

placed in service. Any reduction in the credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits cannot exceed 50 percent.

2. Amendments to I.R.C Section 29

This tax credit is renumbered as I.R.C. Section 45K and extended and modified significantly for facilities producing LFG as a fuel. The extension applies to facilities placed in service after June 30, 1998 and before January 1, 2007. The tax credit would be equal to \$3 per Btu oil barrel equivalent sold (indexed for inflation from 2002) and is provided for a four year period starting on the later of January 1, 2004 or the date the facility is first placed in service, but no tax credits would be provided after December 31, 2009. The value of the tax credit is reduced by a third for facilities located at landfills that are required under the Clean Air Act to install LFG collection and control systems. In addition, the bill imposes an annual, average daily volume limit of 200,000 cubic feet of natural gas equivalent on the amount of LFG that can qualify for the tax credit. A qualified facility that produces LFG and uses it to generate electricity can either take the Section 45 tax credit on the electricity produced or the Section 29 tax credit on the LFG produced, but not both. The tax credit is added to the list of general business credits under I.R.C. Section 38

3. Other Relevant Tax Provisions

a. Energy Credit for Combined Heat and Power (CHP) System Property

The provision provides a 10-percent credit for the purchase of CHP property that has an electrical capacity of less than 15 megawatts or a mechanical energy capacity of less than 2000 horsepower or an equivalent combination of electrical and mechanical energy capacities; that produces at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent in the form of electrical or mechanical power (or a combination thereof); and the energy efficiency percentage of which exceeds 60 percent. CHP property does not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

b. Business Related Energy Credits Allowed Against Regular and Minimum Tax

The tentative minimum tax (which, if it exceeds the regular tax, subjects the taxpayer to the alternative minimum tax) is treated as being zero for purposes of determining the tax liability limitation with respect to the Section 45 credit for electricity produced from a facility (placed in service after the date of enactment) during the first four years of production, beginning on the date the facility is placed in service.

c. Natural Gas Gathering Lines Treated as 7-Year Property

A statutory 7-year recovery period and a class life of 14 years is established for natural gas gathering lines; and there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to such property. A natural gas gathering line is defined to include any pipe, equipment, and appurtenance that is (1) determined to be a gathering line by the Federal Energy Regulatory Commission, or (2) used to deliver natural gas from the wellhead or a common point to the point at which such gas first reaches (a) a gas processing plant, (b) an interconnection with an interstate transmission line, (c) an interconnection with an intrastate transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

d. Natural Gas Distribution Lines Treated as 15-Year Property

A statutory 15-year recovery period and a class life of 35 years is established for natural gas distribution lines. There is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to such property.

e. Alternative Motor Vehicle Credit

A credit is provided for the purchase of a new alternative fuel vehicle equal to 40 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards, but not more than between \$5,000 and \$40,000 depending upon the weight of the vehicle. Alternative fuels comprise compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid fuel that is at least 85 percent methanol. Qualifying alternative fuel motor vehicles are vehicles that operate only on qualifying alternative fuels and are incapable of operating on gasoline or diesel.

D. Other Provisions There are several other non-tax provisions in H.R. 6 that are relevant to developers of energy projects utilizing landfill gas. The following provides a brief description of those provisions.

1. Renewable Energy Production Incentive (REPI)

The existing federal REPI program is modified to prohibit DOE from assigning more than 60 percent of appropriated funds in a given year to facilities that use solar, wind, geothermal, or closed-loop (dedicated energy crops) biomass technologies to generate electricity in order to allow the remaining 40 percent to be assigned to other projects such as LFG projects. The REPI program is extended through 2023.

2. Federal Purchase Requirement

A market for renewable energy is created by a requirement that the Federal Government use electricity produced from renewable energy in an amount not less than 3% of the total amount of electric energy it consumes in years 2005 through 2007, not less than 5% in 2008 through 2010, and not less than 7.5 % in 2011 and each year thereafter. The amount of renewable energy is doubled if it is produced and used on-site at a Federal facility or is produced on Federal lands and used at a Federal facility.

3. Renewable Content of Motor Vehicle Fuel

Total motor vehicle fuel sold in the U.S. by refiners, blenders, and importers on an annual average basis must contain specific volumes of renewable fuel: 3.1 billion gallons in 2005 increasing each year to 5.0 billion gallons in 2012. Ethanol derived from MSW or other waste materials and [liquid] natural gas from a biogas source including landfills are defined as a “renewable fuel.” One gallon of ethanol derived from MSW is considered to be the equivalent of 1.5 gallon of renewable fuel. Production of motor vehicle fuel containing renewable fuels beyond the mandated amounts allows the producer to obtain credits that may be sold and traded to entities that are required to meet the mandate

4. PURPA’s Mandatory Purchase Obligation

No electric utility will be required to enter into a new contract to purchase electric energy from small power production facilities, such as a waste-to-energy plants or LFG electric power production facility, if the Federal Energy Regulatory Commission (FERC) finds that the facility has access to a competitive wholesale market for the sale of electricity. Existing purchase contracts are grandfathered. No electric utility will be required to purchase from a new qualifying cogeneration facility unless the facility meets the criteria for such facilities to be established by FERC. FERC is also authorized to modify the ownership limitations for qualifying small power production and cogeneration facilities.

5. Pricing of Generator Interconnections to Transmission Lines

Any transmission provider may submit to FERC a plan containing the criteria for determining the entity that will be required to pay for any construction of a new generator interconnection. No costs related to the interconnection may be allocated to an electric utility if the native load customers of that utility would not have required the new generator interconnection.

6. Net Metering

A commercial electric consumer being served by a local utility that develops an on-site generating facility fueled by LFG, or other renewable fuel, is allowed to deliver

electric energy generated in excess of its own needs to the utility. The utility in return is to provide the consumer a credit for each kilowatt-hour of electricity so delivered on the consumer's next electric power bill.

7. Open Access by Unregulated Transmission Utilities

FERC is given authority to regulate rates, terms and conditions for transmission service, including generator interconnections, by State or local government-owned transmission systems.

8. Standard Market Design

FERC's proposed Standard Electricity Market Design (SMD) rulemaking (discussed below) is remanded to the Commission for reconsideration. No final rule mandating a SMD may be issued before October 31, 2006, or take effect before December 31, 2006. Any final SMD rule issued by the Commission is to be preceded by a second notice of proposed rulemaking issued after the date of enactment of this Act and an opportunity for public comment.

9. Commercial Byproducts from Municipal Solid Waste

DOE is to establish a program to provide guarantees of loans, with maturities of not more than 20 years, by private institutions for the construction of facilities for the processing and conversion of MSW into ethanol fuel and other commercial byproducts. The full faith and credit of the United States is pledged to the payment of all guarantees made under the provision.

10. Waste-Derived Ethanol Conversion Assistance

DOE is authorized to provide grants for the building facilities that will produce MSW-derived ethanol. \$100 million is authorized to be appropriated for such grants in FY 04, \$250 million in FY 05, and \$400 million in FY 06.

II. GREENHOUSE GAS CONTROLS

A federal program that either mandates or seeks voluntary but robust reductions of greenhouse gases is expected to create an active market for the trading of such reductions. Reductions in methane emissions, a greenhouse gas, from LFG projects, either through flaring or beneficial use of the gas, could be sold and purchased if the federal program allows reductions of carbon dioxide or carbon dioxide-equivalent emissions from sources other than the targeted sources, most likely electric power plants, to be part of the trading scheme. Importantly, each ton of methane that is controlled would be equivalent to controlling 21 tons of carbon dioxide. However, to date very little has occurred at the federal level to spur creation of such a market.

A. Congressional Efforts

On October 30, 2003, the Senate rejected a bill, S 139, the Climate Stewardship Act of 2003, by a narrow margin of 55-43 that would have imposed the first federally-mandated limits on emissions of carbon dioxide. The legislation would have required a reduction in the nation's carbon dioxide emissions to 2000 levels by the year 2010 from the electricity generation, transportation fuels, industrial, and commercial economic sectors (as those terms are defined in the Inventory of U.S. Greenhouse Gas Emissions and Sinks, prepared in compliance with the United Nations Framework Convention on Climate Change Decision 3/CP.5). The bill would also have created a market for covered companies to trade and sell pollution credits modeled after the successful acid rain trading program of the 1990 Clean Air Act. LFG projects would have benefited from a provision in the bill that allows a covered entity to meet up to 20% of its mandated reduction by submitting greenhouse gas emission reductions achieved by a non-covered entity as long as that entity had registered its reductions in the National Greenhouse Gas Database. The last time the full Senate addressed greenhouse gas emissions was in 1997 when it voted 95-0 not to support the international Kyoto Protocol on slowing climate change.

The White House had urged Senators to oppose the bill arguing that it would increase household energy bills, increase gasoline prices, reduce the number of jobs, increase unemployment and increase the federal deficit. During the floor debate, Senators Joe Lieberman (D-CT) and John McCain (R-AZ), the two sponsors of the bill, cited a recent study by the Massachusetts Institute of Technology that estimated the bill would annually cost less than \$20 per household and would reduce the U.S. gross national product by no more than .01 percent.

B. Litigation Against EPA

The EPA has been sued after it denied a petition on August 28, 2003, filed by plaintiff environmental groups and others in 1999, in which they sought action by EPA to control greenhouse gas emissions, primarily carbon dioxide, from motor vehicles. The groups cited the environmental and human health effects of global warming. The environmental groups argue that Section 202 of the Clean Air Act requires EPA to regulate air pollutants from mobile sources that cause or contribute to "air pollution which may reasonably be anticipated to endanger public health and welfare." Vehicle emissions of carbon dioxide, methane, nitrous oxide and hydrofluorocarbons account for one-third of the nations' manmade greenhouse gas emissions. The groups contend that these emissions should be treated as "pollutants" under the CAA.

The Agency gave as its reason for denying the petition that Congress has not granted it clear legal authority under the Act to regulate greenhouse gases for climate change purposes. The Bush Administration has formally taken the position that greenhouse gas emissions are not the type of emissions covered by the CAA, and, therefore, EPA has no authority to regulate greenhouse gas emissions.

The attorney generals of Connecticut, Massachusetts, and Maine are also committed to challenging EPA's denial of the petition and its determination that it lacks the requisite authority. Meanwhile, seven other state attorneys general, led by New York, may file a legal challenge similar to the one filed in a federal district court in California where the Sierra Club is seeking to force EPA to establish new source performance standards (NSPS) under the CAA that restrict carbon dioxide emissions from power plants and other industrial facilities.

C. Administration Initiatives

The Administration is currently hard at work trying to get the nation's industries to voluntarily commit to concrete steps under its voluntary program to reduce the nation's greenhouse gas (GHG) emissions. The Administration is hoping it can announce next month that memoranda of agreements have been reached with various sectors of industry and agriculture under which the respective sectors will agree to monitor and reduce their greenhouse gas emissions to specific levels by target dates. The Administration's voluntary program was announced by President Bush in February 2002 and is intended to cut GHG emissions 4.5 percent by 2012 and reduce the growth rate of carbon dioxide emissions by 18 percent in 10 years. The CO₂ emission reduction targets would be periodically indexed to the gross domestic product, increasing in times of economic growth and decreasing when the economy declines. It is hoped the program will spur creation of a market for trading voluntary reductions in carbon dioxide, and perhaps other greenhouse gases on a carbon dioxide - equivalence basis.

The current effort to forge MOAs with industry is in response to half-hearted response by the nation's companies to EPA's current voluntary efforts to curb greenhouse gas emissions. Those efforts include Climate Leaders - a voluntary industry/government partnership under which companies work with EPA to evaluate their emissions, and set aggressive reduction goals, and SmartWay - a partnership with the trucking and railroad industry to develop and deploy fuel-efficient technologies and practices, such as idling strategies, to achieve substantial fuel savings and emission reductions.

Presently, representatives of several key energy and electric utility companies and large manufacturing companies, and their respective national associations, are negotiating with DOE on the contents of a MOA. Similar discussions are taking place between the Department of Agriculture and the farming community which focuses on voluntary measures that would sequester carbon dioxide. It is hoped that the national trade associations will take on some of the responsibility of educating and encouraging their members to participate in the program. In addition to possible federal funding and technical assistance, under the MOA if real emissions reductions were achieved, the participating businesses would be provided assurance that they will not be penalized for their reductions under any future mandatory greenhouse gas regulatory scheme.

Interestingly, when it was first announced, the President's program proposed to provide \$4.6 billion in tax credits over five years for development of renewable sources of energy and for private investments in new technologies that reduce greenhouse gas

emissions. That amount included \$439 million for development of landfill gas-to-energy projects. These commitments will be eclipsed by the value of the tax credits for renewables in HR 6 if the bill becomes law.

III. FEDERAL ENERGY REGULATORY COMMISSION

FERC continues to pursue an independent transmission grid and independent power market operation in order to create a level playing field on which all resources – renewable resources such as LFG projects, distributed generation, and supply and demand resources – can compete. Recently, FERC issued significant regulatory proposals that if adopted should facilitate development and utilization of electric power generated by LFG projects.

A. Standard Market Design

On July 31, 2002, FERC issued proposed rules on a standard market design for wholesale electric energy markets, including a comprehensive plan for mitigating market power and market manipulation. *Remedying Undue Discrimination through Open Access Transmission Service and Standard Electricity Market Design* (Docket No. RM01-12-000). The proposed rules are intended to provide certainty to all market participants, encourage new infrastructure investment, promote fair competition and prevent a repeat of the mistakes made previously in California. The proposed rules would remedy remaining undue discrimination in the use of the nation's interstate transmission grid and also provide a solid platform to ensure that wholesale markets produce just and reasonable rates for customers. Of particular importance, the proposed SMD will complete the nation-wide transition to independent transmission system operators (ISOs) and the formation of Regional Transmission Organizations (RTOs) which would plan and arrange construction and maintenance of transmission infrastructure.

The proposed SMD rules were received with mixed reactions by the electric power industry. In particular, there is much resistance by some large vertically integrated utilities to the requirement that they hand over control of their transmission systems to an ISO or RTO. Those utilities played a significant role in having Congress add a provision to the pending energy bill prohibiting FERC from adopting final SMD rules before 2007 (see above).

B. Incentives for Efficient Operation of the Transmission Grid.

On January 15, 2003, the Commission sought to give guidance on transmission incentives to help encourage needed investment in transmission infrastructure and improve grid performance. *Pricing Policy for Efficient Operation and Expansion of the Transmission Grid* (Docket No. PL03-1-000). The proposed incentives include an incentive adder for all public utilities equal to an additional 50 basis points on its return on equity for transfer of operational control of transmission assets to an RTO; an additional 150 basis points for sale of transmission assets to an entity independent of any market participant; and an

additional 100 basis points for investments in new transmission facilities.

C. Small Generator Interconnection Standards

FERC issued a proposed rule which sets forth standard procedures and a standard agreement for the interconnection of generators of 20 megawatts and smaller intended to facilitate development of needed infrastructure for the nation's electric power system. (68 FR 49973, August 19, 2003). The expedited procedures for small generators will reduce interconnection time and cost, help preserve reliability, increase energy supply, and increase the number and variety of independent generators that can compete in the wholesale electricity markets. The interconnection procedures must be followed by the public utility transmission provider and an interconnection customer throughout the interconnection process. The proposed rule is one state regulators could also use for generator interconnections under their authority.

The proposed rule includes super-expedited procedures for interconnecting pre-certified generators 2 MW or less to a low voltage electric system; expedited procedures for interconnecting generators between 2 and 10 MW to a low voltage electric system; and, expedited procedures for interconnecting small generators to a high voltage electric system – 69 kilovolts and above – and for generators larger than 10 MW to a low voltage electric system. The standard small generator interconnection agreement sets out the legal rights and obligations of the parties, including cost responsibility, milestones for the project's completion, and a process for resolving disputes. The rule does not require changes to individual interconnection agreements filed with the Commission prior to the effective date of a final rule.